

Essential Utilities Inc., (WTRG)

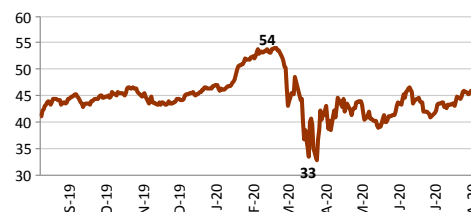
Strong Peoples Contribution Drives Earnings Beat

Reiterate Outperform rating after Q2 earnings release. WTRG reported results which exceeded our/consensus estimates driven by a better-than-expected contribution from Peoples. The company reaffirmed 2020 adj. EPS guidance, and continues to target ~\$950M of regulated system investment for the year. We will look for an update on the DELCORA acquisition (transaction close previously expected early 2021), which should drive significant rate base and earnings growth, when completed. We will look for more information on the Q2 conference call, which will be held today at 10 a.m. CT.

- **Q2 results exceeded our/consensus EPS driven by a better-than-expected contribution from Peoples.** Q2 revenue was ~\$384M vs. our/consensus estimates of \$375M/\$371M, driven by a \$149.6M contribution from Peoples (we modeled \$144M for the quarter) and rate increases & surcharges (\$7.6M). EPS was \$0.29 vs. \$0.20/\$0.23, largely related to lower-than-expected purchased gas costs (\$43M in Q2, vs. our \$60M estimate). We will look for more information on the Q2 earnings call.
- **Importantly, WTRG reaffirmed 2020 guidance; continuing to monitor COVID impacts, though volumes have been fairly resilient thus far.** WTRG continues to expect \$1.53 to \$1.58 in adj. EPS in 2020, ~\$950M of regulated system investments (\$550M in water, ~\$400M in natural gas), and annual rate base growth of 6%-7% for water and 8%-10% for gas. Importantly, Q2 water sales increased 0.3% in Q2, as 10% growth in residential consumption (66% of quarterly consumption) more than offset the declines in commercial & industrial (-16% and -11%, respectively).
- **Substantial dividend increase (~7% annualized) highlights commitment to returning capital to shareholders and long-term value proposition.** WTRG recently increased its dividend ~7%; annualized dividend now amounts to a ~2.2% yield based on the August 5 closing price. WTRG has grown the dividend at a 7.2% CAGR since 2014, and we expect growth to continue, consistent with rate base and EPS growth.
- **Acquisition activity should continue to drive customer growth in the water business; will look for an update on DELCORA acquisition process (previously expected to close in early 2021).** WTRG has closed two acquisitions YTD (~\$28.3M of cumulative rate base) and has signed purchase agreements totaling 203k customer connections (~\$315M in rate base, on aggregate); we expect this will add ~\$15M to annual earnings potential. These figures include the ~\$276.5M (~198k retail customer) DELCORA acquisition, which is the largest municipal acquisition in company and Pennsylvania history; we will look for an update on potential transaction timing on the conference call.
- **WTRG's Q2 earnings call will be held today at 10:00 a.m. CT.** The call can be accessed at www.ir.aquaamerica.com.

ESTIMATE CHANGE

1-Year Price Chart



Stock Data

Rating:	Outperform
Suitability:	Lower Risk
Price Target:	\$46
Price (8/5/20):	\$44.69
Market Cap (mil):	\$11,398
Shares Out (mil):	255.1
Average Daily Vol (mil):	1.14
Dividend Yield:	2.2%

Estimates

FY Dec	2019A	2020E	2021E
Q1	0.28 A	0.60 A	
Q2	0.37 A	0.29 A	
Q3	0.48 A	0.22 E	
Q4	0.34 A	0.43 E	
Fiscal EPS	1.47 A	1.55 E	1.68 E
Fiscal P/E	30.4x	28.8x	26.6x

Chart/Table Sources: FactSet and Baird Data. Price chart reflects most recent closing price.

Please refer to Appendix
- Important Disclosures
and Analyst Certification

Essential Utilities is a regulated water, wastewater, and natural gas utility serving customers primarily in the eastern half of the U.S.

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Investment Thesis

US water infrastructure needs should drive long-term earnings growth. The water infrastructure in the United States is in significant need of upgrade and expansion. We believe a significant long-term earnings growth driver for WTRG comes from substantial capital investment opportunities, which contribute to rate base growth, and in turn, drives earnings.

Peoples acquisition, a natural gas utility, should add another platform for organic growth. The combined entity is expected to have ~\$10.8B in assets and a rate base of >\$7.2B, 70% in water and wastewater and 30% in natural gas. We estimate WTR paid ~14.8x EV/EBITDA (based on an enterprise value of \$4.275B and 2019E EBITDA of \$289M) for the assets. The transaction is expected to close in mid-March.

Planned capital investment should expand rate base and generate growth for the company in the long run. We expect WTRG's long-term EPS growth to be fueled in part by the company's ~\$950M annual capex investment. Investments are typically targeted for states with enhanced recovery mechanisms which help stabilize margin and earnings consistencies despite accelerated investment.

The majority of WTRG's regulatory operations are located in states that maintain enhanced regulatory recovery mechanisms. The majority of WTRG's current operating system employs infrastructure mechanisms, which allow a return on investment outside of a full rate case, substantially reducing regulatory lag time and minimizing rate case activity. These regulatory mechanisms include infrastructure investment riders, statewide rates and incentive mechanisms for acquisitions of troubled water systems. We believe such mechanisms provide a constructive regulatory environment in which to make capital investments, enabling improved and more consistent earned returns, which should lead to a premium peer valuation.

Continued municipal water acquisitions should help customer growth. The company targets 2-3% customer growth in 2020 driven by acquisitions of municipal utilities. Aqua has successfully acquired numerous water and waste water systems in the past decade to supplement its internal growth. Acquisitions also provide significant follow-on investment opportunities as WTR improves the quality of an acquired water system. The company is expected to be a key player in consolidating some of the 53,000 private water systems in the U.S., and rehabilitating those systems to improve water quality and drive investment growth.

\$46 price target. Our price target is based on a ~26x P/E multiple on our 2022 EPS estimate, which is in line with comps which are currently trading at a ~24x-31x multiple. We believe this is justified as WTR integrates the Peoples acquisition.

Risks & Caveats

Our suitability rating on Essential Utilities is Lower Risk. Key risks include the following.

Regulation. Regulated operations are subject to local, state and federal regulations. Changes in the regulatory environment can affect WTRG's near-term and long-term performance.

Weather. WTRG's businesses are sensitive to fluctuations in the weather. Particularly wet or dry weather can impact near-term financial results.

Acquisition risk. WTRG may have the opportunity to purchase assets or companies in the near future. Acquisitions carry risks related to personnel, expected-versus-actual growth and a myriad of unforeseen hurdles, all of which can negatively affect earnings.

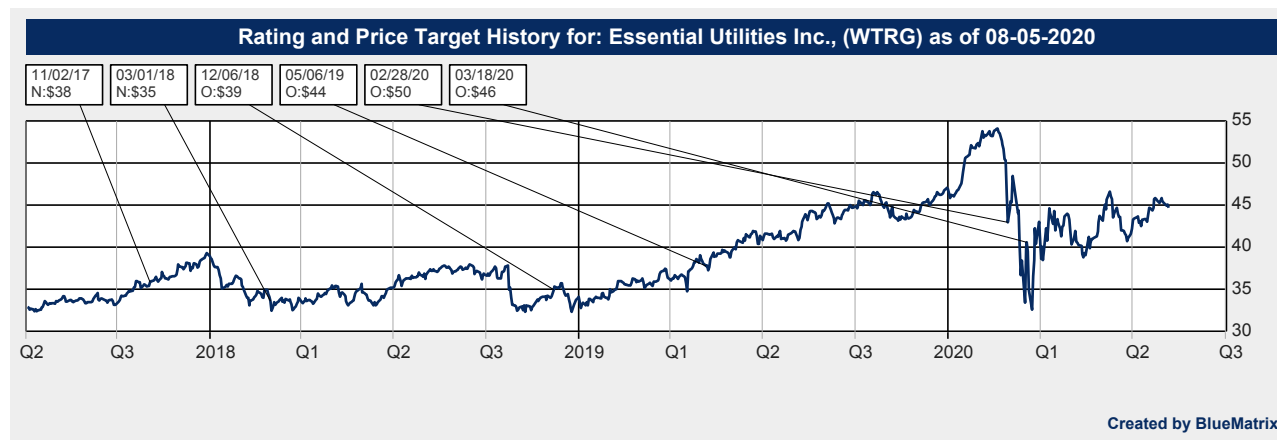
Product quality. Unique among its sister regulated utility sectors, water utilities provide a product that is ingested. Despite robust mandated service quality standards that lower risk, a quality failure could materially impact the earnings and stock of WTRG.

Company Description

Essential Utilities is a holding company for regulated utilities providing water and waste water services to nearly 3 million people located in the eastern half of the U.S. Over 50% of operating revenues and net income are derived from Pennsylvania.

Appendix - Important Disclosures and Analyst Certification

Approved on 05 August 2020 22:44EDT/ Published on 06 August 2020 01:05EDT.



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1 Robert W. Baird & Co. Incorporated makes a market in the securities of WTRG.

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